



# Ready or not: The first new 403(b) regulations in more than 40 years are here

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BY GINNY BOGGS

## BRAND NEW 403(b) RULES BRING SIGNIFICANT CHANGES

In the words of the IRS, “On July 23, 2007, a momentous event occurred in the world of 403(b) [plans] with the issuance of the first comprehensive regulations in 43 years.” The new regulations generally will take effect Jan. 1, 2009.

The new 403(b) regulations will bring significant changes for tax-exempt organizations (i.e., nonprofits, public schools, universities, and hospitals) and their employees, including:

- Increased employer fiduciary responsibility
- Written plan document requirement
- Written description of all available investment options
- Stricter transfer rules
- Bright-line test for universal availability rule
- Annual meaningful notice to plan participants
- Other changes regarding deposits, catch-up contributions, Form 5500, and plan termination

**Compliance with these changes is crucial. Failure to comply could result in substantial IRS and/or Department of Labor (DOL) penalties, which potentially could be imposed not only on the organization itself, but also on the individuals at the organization who are responsible for the plan’s management and oversight. Additionally, failure to comply with the IRS rules could result in adverse tax consequences to employees who participate in the 403(b) plan.**

The intent of the IRS is for the new 403(b) regulations to increase similarity in the rules governing 403(b) plans, 401(k) plans, and 457(b) governmental plans. In addition, the new regulations will reflect the IRS’s point of view that an employer offering a 403(b) plan will have greater responsibility for overseeing the plan. Because of

this, the new 403(b) rules significantly change the way 403(b) plans are managed.

## CURRENT STRUCTURE

The stagnant 403(b) rules have fostered a stagnant 403(b) marketplace, while their 401(k) and 457(b) plan cousins have experienced significant marketplace improvements that benefit plan participants. In contrast, 403(b) plans have languished and are still typified by a hands-off management approach with little employer involvement, a *more vendors are better* philosophy, and an excessive number of investment options. These characteristics overwhelm the average 403(b) plan participant.

Unlike the 401(k) single-vendor environment, employers using multiple 403(b) plan vendors have done little or no monitoring of investment options and their performance. This causes employers and employees to frequently miss best-in-class investment managers and has made it difficult to determine the competitiveness of investment and administration fees. The existence of unmonitored excessive choice has become a detriment for employees, overwhelming them with choices and diluting the overall quality of investments.

Issues that exist in the current hands-off multiple vendor 403(b) market include:

- Without a single, unified platform for all 403(b) investments, it is challenging for the employer to develop a communication strategy for employees, making it diffi-

## THE HIGH COST OF HIDDEN FEES

The employee benefits world has been abuzz with talk of hidden fees. The potential impact on retirees' bottom lines can be significant: a few additional basis points in fees can undermine a retiree nest egg, as shown in the illustration below.

To date, the problem of hidden 401(k) fees has received most of the attention. But 403(b) hidden fees tend to be even higher because of outdated rules, annuity-type products that possess confusing fee structures, and employers that are in the dark about their employees' savings options.

Variable annuity contracts are common 403(b) plan investments. Though frequently *clones* of mutual funds inside an insurance *wrapper*, when compared with the average costs of mutual funds, the average costs of variable annuities are typically much higher.

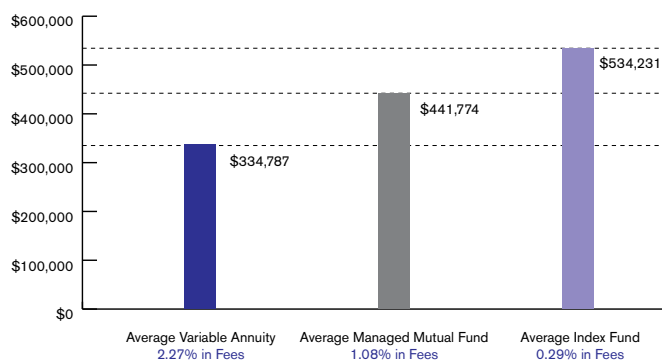
Besides the higher fees, variable annuities also typically carry with them additional charges, such as high surrender charges if money is withdrawn within a certain number of years and annual contract charges. The result of the higher overall costs of annuity-type investments compared to mutual funds is lower investment returns, translating to fewer retirement dollars.

This illustration compares the effect of fees on the investment growth of the average variable annuity with the average managed mutual fund and the average index mutual fund.

As shown here, assuming contributions of \$250 a month over 35 years with an annualized rate of return of 8 percent, the average variable annuity would grow to only \$334,787 after 35 years, while the managed mutual fund would grow to \$441,774 and the average index fund would grow to \$534,231—differences of \$106,987 and \$199,444, respectively.

### How Fees Affect Returns

Value after 35 years,  
assuming \$250 contributed monthly with an 8 percent average annual return.



Source: Average annual fees for variable annuity—Variable Annuity Research and Data Service (VARDS), a unit of Morningstar, Inc.; average annual fees for mutual funds—categories analyzed in Morningstar.

cult to educate employees regarding appropriate investment allocation strategies for their various *life stages*.

- Employees may rely on the investment management firms themselves for education on the plan and investment options, which can lead to biased information that is certain not to include the entire scope of vendors and options available under the plan.
- Because of the overwhelming number of investment options/vendors made available, participation is diminished.

Employees are reluctant to make a decision for fear that they may make the wrong decision.

- With typical 403(b) products (commonly high-cost annuities), it is often complicated for employers to know exactly what costs are involved with their plan and if they are reasonable and competitive. These costs are often hidden, and it is difficult for employers to understand exactly how much is being paid to service providers. (See “The High Cost of Hidden Fees” sidebar above.)

## WHAT'S CHANGING?

Once the new 403(b) regulations take effect, 403(b) plans will look much more like 401(k) plans. The regulations clarify several points on fiduciary responsibility and specifics of written legal plan documents. They also encourage employers to limit the number of recordkeeping/administrative vendors offered in order to make fiduciary and administrative responsibilities more easily attainable.

The new regulations introduce important due diligence and compliance expectations that will reshape the way tax-exempt employers must oversee and manage their 403(b) plans. Increased fiduciary responsibility of employers sponsoring 403(b) plans will mean accountability for fees paid to service providers (all fees, whether transparent or hidden), compliance and oversight of plan providers and plan provisions, and communicating and delivering a prudent investment platform to employees.

Among the most significant changes are:

- **Increased employer fiduciary responsibility.**

The new regulations will impose due diligence and compliance criteria that will require employers to assume a greater fiduciary role, and the potential liability that comes with it. Consequently, employers must act in the best interest of employees.

Added fiduciary responsibility will necessitate developing an investment policy statement with guidelines for selecting, monitoring, and evaluating plan investment options, as well as forming an investment committee that meets regularly to review investment performance, plan expenses, and employee education and keeps well-documented minutes of each meeting. This required monitoring by employers sponsoring 403(b) plans will lead to

a demand for better investment products, greatly benefiting the employees.

In addition, employers will be required to coordinate compliance with all IRS plan limitations, including loan and distribution rules, among all providers, whereas in the past, the employer simply had to ensure only compliance with contribution limits.

**Although plans that are not subject to the Employee Retirement Income Security Act of 1974 (ERISA) are exempt from the Department of Labor's (DOL) fiduciary rules, applicable state law may impose similar rules.**

- **Written plan document requirement.** For the first time, 403(b) plans must have a written plan document and must be operated according to the plan's written terms, similar to 401(k) plans. This rule will apply to all 403(b) plans, regardless of whether the plan consists of employee deferrals only or a combination of employee deferrals and employer contributions. There must be a central plan document that includes all of the material provisions regarding eligibility, benefits, contribution limits, *available investment options*, loans, hardship withdrawals, distributions, fund transfers, and rollovers. The central plan

document may include other documents by reference (e.g., the funding vehicle contract or agreement), together forming the overall terms of the plan, with the central plan controlling if there are conflicting provisions. However, the regulations clarify that in the case of a plan that is funded through multiple issuers, it is expected that an employer would adopt a single plan document to coordinate administration among the issuers, rather than having a separate document for each issuer.

The new requirement for a written 403(b) plan document will lead most employers to choose a single or-

**A SINGLE PROVIDER WITH ACCESS TO MULTIPLE FUND FAMILIES CAN PROVIDE A FULL RANGE OF INVESTMENT OPTIONS, ALLOWING DIVERSIFICATION ACROSS THE BEST ASSET CLASSES, LOWER AND MORE TRANSPARENT FEES, CUSTOMIZED EMPLOYEE EDUCATION AND COMMUNICATION, AND SINGLE-SOURCE ADMINISTRATION TO SEAMLESSLY COMPLY WITH THESE NEW RULES.**

ganization to provide recordkeeping/administration services because of the need to include in the plan document all available investment options and to identify who is responsible for the coordination of compliance with all IRS plan limitations, including the loan, distribution, and hardship withdrawal rules, on an aggregate basis, across all providers and investment options. Given today's environment of fee disclosure and transparency, the employer will be able to choose best-in-class investment funds for each available investment option.

The IRS is expected to publish model 403(b) plan provisions that may be used by employers that do not have existing plan documents. It is anticipated that once the new rules are in place, the IRS will implement a program similar to its determination letter program that applies to 401(k) and other *qualified* plans, for submitting written 403(b) plans to the IRS for review and approval.

The written plan document requirement will significantly increase the potential liability of employers who sponsor 403(b) plans relative to IRS qualification failures, which could result in adverse tax consequences to plan participants.

**In general, 403(b) plans that allow only employee salary deferral contributions, for which employer involvement is essentially limited to transmitting the employee contributions to the investment vehicles, are not subject to ERISA. There was some concern that the new written plan document requirement would now subject such plans to ERISA. According to a July 24, 2007, DOL Field Assistance Bulletin, the DOL is of the view that employee salary deferral-only 403(b) plans should be able to comply with the new 403(b) regulations and still meet the criteria for the ERISA exemption. However, the DOL does note that the new 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement under a 403(b) plan. The question of whether any particular employer, in how it goes about complying with the 403(b) regulations, has taken on a role that subjects the plan to ERISA must be analyzed on a case-by-case basis.**

- **Available investment options.** All investment options available under the 403(b) plan must be described within the plan document. Consequently, employers must designate approved investment providers and products in the written plan document. Having to list all available vendors and investments in the written plan document will likely force employers to limit the number of vendors and investment options offered.
- **Stricter transfer rules.** 403(b) plans will be subject to transfer rules similar to those that apply to 401(k) plans. Currently, a 403(b) participant can transfer some or all of an account balance at any time from an employer-sponsored vendor to any other vendor, even one not offered by the participant's employer (subject to plan restrictions). Such transfers are called *90-24 transfers* after the IRS revenue ruling that allows them. Once the new regulations take effect, 90-24 transfers will no longer be allowed. Instead, only two types of transfers will be allowed: (1) transfers/exchanges within the same 403(b) plan, among employer-approved investments, as spelled out in the plan document, and (2) transfers to another 403(b) plan, but only if the individual making the transfer is an employee or former employee of the receiving plan's employer/plan sponsor, and the plan documents of both plans allow for this.

In either case, the value of the participant's plan benefit may not be less than his benefit before the transfer/exchange, and the distribution restrictions imposed after the transfer/exchange may not be less stringent than those imposed before the transfer/exchange.

- **Bright-line test for universal availability rule.** Under what is known as the *universal availability rule*, employers sponsoring a 403(b) plan are required to offer the plan to all employees, with limited exceptions (i.e., non-resident aliens, certain students, employees who normally work fewer than 20 hours per week).

There is currently no bright-line test for the fewer-than-20-hours-per-week exception, which can be

problematic in the instance of employees whose schedules are irregular (e.g., substitute teachers).

The new regulations will establish a bright-line universal availability test of 1,000 hours of service. New employees who are hired with the expectation of working fewer than 1,000 hours in their first year of employment may be initially excluded, but would have to be included if they ever complete 1,000 hours in a year.

**There is no change in the rules that apply to plans that are subject to ERISA. ERISA plans may not apply the 20-hour-per-week exclusion, and may exclude “part-time” employees only under the fewer-than-1,000-hour rule described above.**

- **Meaningful notice to plan participants.** Besides being universally available, the 403(b) plan must also be effectively available. For instance, if an employee is eligible to participate in the plan but is unaware because he has not been notified that he may participate, the plan is not considered to be available to him. Therefore, the new regulations will require an employer to provide an annual *meaningful notice* to all eligible employees of their rights to participate in a 403(b) plan and an effective method for making and changing their deferral elections.
- **Deposit requirements.** Employers must transmit the employees' salary reduction contributions to the 403(b) plan's investment vehicle as soon as is reasonable for proper plan administration. For this purpose, the regulations cite an example of no later than 15 business days after the month in which the amounts would have been paid to the employee.

**403(b) plans that are subject to ERISA are already subject to similar, yet somewhat stricter, DOL rules that require the deposit of employee deferrals on the earliest date the employer can reasonably segregate and transmit them, but not later than 15 business days after the month the deferrals are made.**

- **Catch-up contributions.** The rules will require coordination of the special catch-up contribution (re-

quiring 15 years of service) with the age-50 catch-up contribution. An employee may be eligible for both types of catch-up contributions, but any excess deferral amount first will be counted toward the special catch-up contribution, and then toward the age-50 catch-up contribution. This is yet another reason to have a single service provider that can coordinate and monitor these limits.

- **Plan termination.** The new regulations will allow 403(b) plans to be terminated. All accumulated benefits under the plan must be distributed to participants and beneficiaries as soon as administratively possible after termination of the plan.
- **Commingling assets.** To the extent permitted by the IRS in future guidance, assets held in 403(b) mutual fund custodial accounts may be pooled with trust assets held under 401(k) and other qualified plans.
- **Expanded IRS/DOL Form 5500 reporting.** Although not part of the new 403(b) regulations, new proposed 5500 reporting rules will most likely require the same extensive reporting and independent audit requirements that apply to 401(k) and other qualified retirement plans beginning with 2009 plan year returns due in 2010. Currently, 403(b) plans have far simpler and far less costly annual reporting requirements on Form 5500, including not having the expensive independent auditor requirement applicable to qualified plans with more than 100 plan participants.

403(b) employer/plan sponsors should not underestimate the time and energy it will take them to have an independent audit conducted. Numerous records and data will be required from the employer and each vendor. This is yet another reason why employers should consolidate their existing 403(b) offerings into a single provider that has access to multiple fund families.

**Plans that are not subject to ERISA are exempt from Form 5500 reporting.**

## WHAT YOU NEED TO DO RIGHT NOW TO GET READY FOR THE CHANGES

Employers and their vendors and providers have only until the end of 2008 to prepare for the new 403(b) rules. Employers should take a number of steps to make plan operations and management easier and address the additional complexity as a result of the new fiduciary responsibilities and due diligence requirements.

In order to get ready for the changes the new rules will bring starting in 2009, you should do the following, beginning right now:

- Implement a written plan document if you do not currently maintain one. If you do have a written document already, you should review it for compliance with the new rules.
- Develop an investment policy statement that creates guidelines by which investment options will be selected, fund performance evaluated, and, if necessary, replaced. Fiduciary standards dictate regularly evaluating fund options. By limiting the number of fund options available, employers also reduce complexity and administrative oversight.
- Create a list of all of your existing providers, and review them for investment performance, investment options, fees, expenses, and service standards. This is very important because the new rules require that the written plan document include both a description of all investment options available under the plan and a list of approved investment providers for exchanges and transfers.

Many 403(b) employers will find that their list of vendors has become quite sizeable over time. Employers should get a handle on all of their current providers and find out exactly what types of products and services are being offered and exactly what fees and surrender charges are being imposed. Because of the need for increased oversight and expanded fiduciary responsibilities, employers with numerous vendors should strongly consider moving to a single vendor.

The new regulations encourage employers to reduce the number of vendors and investment options available in their 403(b) plans, which will benefit both employees and employers.

- Develop and issue a request for proposals (RFP) spelling out requirements, and distribute to current and potential vendors. Scrutinize vendors that promise no-cost administration and/or offer investment products. Resist the temptation to stay with your existing vendors to make your job easier. Remember that increased fiduciary responsibility means there is an obligation to put your employees' needs first. To accomplish this, you should engage in a transparent vendor- and fund-selection process to search for the best quality at the lowest cost to employees.

The RFP process will allow you to evaluate your current vendors to see if they are ready for the changes. It will also document that you have performed the appropriate due diligence in the vendor-selection process.

As part of this process, you should determine the total amount of 403(b) plan assets under management. Consolidating investments through a competitive RFP process will allow you to use your combined plan assets for greater purchasing power, resulting in reduced fund fees and administrative expenses. This is yet another reason to consider one consolidated service provider.

- Offer impartial employee education. This could be in the form of a Web site and/or literature, and/or educational seminars—not affiliated with vendors.
- Form a plan committee and/or an investment committee to oversee and manage your 403(b) plan. Establish fiduciary criteria, create procedures to monitor your plan and vendors on an ongoing basis, and assess the need for hiring outside advisory expertise.
- Consider adding the Roth 403(b) option. Since you may be drafting a new plan document or amending

an existing plan document anyway, it may be a good time to consider adding the Roth option to your 403(b) plan. The Roth feature will give employees the opportunity to make salary deferrals on an after-tax basis and generate tax-free investment earnings (if paid out as a *qualified distribution*).

### HOW CAN MILLIMAN HELP?

At the end of the process, you need your 403(b) plan to not only be in IRS and DOL compliance, but also to provide employees with access to quality, reasonably priced investment choices and services, with no hidden fees.

The new 403(b) regulations present you with a prime opportunity to reduce fees, improve investment performance, and improve the quality of services to your 403(b) plan, resulting in a much-improved retirement vehicle for employees.

Milliman is uniquely positioned to partner with you to achieve these objectives. Our comprehensive services will provide you with the consulting, compliance, plan administration, investment options, investment guidance, employee communications, and overall support you need to meet the Jan. 1, 2009, effective date of the new rules.

- By partnering with Milliman, you can benefit from a single, unified, open investment platform.
- Milliman is able to provide investment consulting assistance to help you select the best investment options from more than 4,000 mutual funds to form the core fund offerings of the plan. In addition, specialty investments can be offered in the plan to target

participants with special needs, such as model portfolios for participants who want assistance with asset allocation, and self-directed brokerage accounts for participants who want to maintain a position in an existing 403(b) fund that will not be retained in the core funds.

- Milliman is also able to provide a single platform for 403(b) administration that would provide ease of transfer among all investment options, *at-a-glance* information on the participants' total 403(b) position, consolidated participant statements, and a Web site for all 403(b) money.
- Having a single platform will also make it easy to collect and reconcile the data needed for the auditors and the required government filings. Because the Form 5500 reporting requirements for 403(b) plans will most likely mirror those of 401(k) plans beginning with the 2009 plan year, Milliman is uniquely qualified to assist you with these functions, as we have both the necessary 403(b) expertise and the systems and processes in place to handle the comprehensive 5500 reporting and audit requirements.
- Milliman is able to assist you with a comprehensive employee communication strategy that would increase participation in, and appreciation of, your retirement program.

*Ginny Boggs is a senior compliance consultant with the Dallas office of Milliman. She can be reached at 214 863.5500 or at [ginny.boggs@milliman.com](mailto:ginny.boggs@milliman.com).*

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